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Central Intelligence Agency

Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

International Financial Situation Report #38
21 March 1985

Summary

The sheer enormity of the debt held by the major debtors has focused the majority of the international financial community's attention on these countries. Nonetheless, the smaller debtors' problems are just as severe if not more so. [redacted] 25X1 [redacted] we see several countries — including Bolivia, Peru, and possibly Chile — as having problems that could be a sign of insolvency, where extraordinary debt relief measures, as in the case of Poland, would be necessary. 25X1 [redacted] these countries will experience considerable difficulty in satisfying external financing requirements in 1985 and 1986. 25X1 Other developments in recent weeks include:

- On 11 March Mexico's $48 billion debt rescheduling agreement was submitted to the country's 530 bank creditors for review, with the target date for final approval being 29 March. Mexico and the IMF are close to agreement on the last phase of the three-year extended fund facility, and a letter of intent is expected to be signed this week.

- Brazil and the IMF are working on a new letter of intent, following last month's suspension of disbursements. The commercial bank negotiations have been suspended until a new agreement with the Fund is worked out, which will not occur until mid-May at the earliest. Paris Club negotiations will begin after an agreement on a Fund program is reached.

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- Yugoslavia formally endorsed a draft agreement with the IMF for a 1985-86 standby arrangement of $300 million, opening the way for completion of rescheduling negotiations with Western banks and governments.

- The refusal of the National Commercial Bank of Saudi Arabia to participate in the new money phase for the Philippines continues to delay signing of the financial rescue package. In addition, the first review of the Philippine IMF standby arrangement began on 4 March and should conclude this week. [redacted] 25X1

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This situation report was prepared by analysts of the Intelligence Directorate. Comments are welcome and may be addressed to the Situation Report Coordinator, [redacted] 25X1

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UPCOMING IMPORTANT DATES

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Date	Event/Country	Comment
25-26 March	Paris Club (Yugoslavia)	Scheduled meeting to discuss rescheduling of Yugoslavia's debt owed to official bilateral creditors.
25-27 March	IDB Annual Meetings (Vienna)	Regularly scheduled annual meetings of the Inter-American Development Bank.
17-19 April	IMF/IBRD Meetings (Washington)	The Interim and Development Committees will discuss various economic and financial topics, including LDC debt problems.
Week of 22 April	Paris Club (Poland, Ecuador, Costa Rica, Mauritania)	Tentatively scheduled meetings to discuss the rescheduling of these countries' debt owed to official bilateral creditors.
2-4 May	ADB Annual Meetings (Bangkok)	Regularly scheduled annual meetings of the Asian Development Bank.
4-7 May	AFDB Annual Meetings (Brazzaville, Congo)	Regularly scheduled annual meetings of the African Development Bank

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KEY ISSUE

Problems in Smaller Debtors

The sheer enormity of the debt held by the major debtors — Brazil, Mexico, Argentina, and Venezuela — has focused the majority of the international financial community's attention on these countries, [redacted] Nonetheless, the smaller debtors' problems are just as severe if not more so. For example, based on discussions with bankers we see several countries — including Bolivia, Peru, and possibly Chile — as having problems that could be a sign of insolvency where extraordinary debt relief, as in the case of Poland, would be necessary. Yet, the "sense of urgency" to assist financially troubled countries has diminished, and the smaller debtors lack the political and economic strength to draw needed attention. [redacted] these countries will experience considerable difficulty in satisfying external financing requirements in 1985 and 1986. The banking community, with less exposure at stake, is reluctant to lend more money and will be more inclined to write off loans to these countries. [redacted] 25X1 25X1 25X1

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DEVELOPMENTS IN MAJOR COUNTRIES

Mexico

On 11 March Mexico's $48 billion debt rescheduling agreement was submitted to the country's 530 bank creditors for review, seven months after the original package was negotiated. [redacted] the long delay to difficulties in working out legal provisions to permit non-US banks to switch up to 25 percent of their total US dollar-denominated loans to the lending country's currency. The target date for final approval is 29 March. [redacted] 25X1 25X1

Mexico and the IMF are close to agreement on the last phase of Mexico's three-year extended fund facility, [redacted] and a letter of intent is expected to be signed this week. The IMF team plans to prepare the final documentation for presentation to the executive board in mid-May. Negotiations took more than four months, and Mexican officials bowed to pressure from the Fund after examining a confidential Mexican assessment that indicated programmed budget and trade policies would cause the economy to stagnate and keep inflation near 60 percent, [redacted] Earlier projections had called for 4.5 percent economic growth and inflation of 35 percent. As a result of the IMF pressure, the government introduced new policy changes to cut public spending and reduce the money supply, which will combat the inflation problem. [redacted] 25X1 25X1 25X1

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In order to encourage exports and stem capital flight, on 5 March Mexico increased the daily depreciation of the peso against the US dollar from 17 to 21 centavos, and last week domestic interest rates were raised. Capital flight, estimated at some $3 billion in 1984, accelerated during the first two months of 1985 to between $500 million and $1 billion, according to Embassy reporting. The Mexican government also began exploring ways to encourage exports, [redacted] Finance officials 25X1 recently announced that government financing for exports will increase by about 30 percent. Mexican officials also plan to allow exporters preference in securing foreign exchange to import needed intermediate and capital goods. [redacted] 25X1

Nonetheless, we believe these measures will be insufficient to substantially improve economic performance. We judge that additional steps are politically unacceptable before the local and gubernatorial elections in July. [redacted] 25X1

Brazil

President Tancredo Neves's principal challenge when he assumes office following his recovery from surgery will be Brazil's unresolved financial negotiations and their associated political hazards. The IMF suspended disbursements to Brazil last month because of the government's inability to control inflation. The bank advisory committee, which had reached tentative agreement on the terms of a multi-year rescheduling agreement for Brazil, also halted negotiations until a new IMF-supported program is in place. In addition, the Paris Club will not discuss rescheduling of Brazil's debt owed to official creditors until a Fund program is in place and Brazil is in full compliance with the bilateral agreements signed or still to be signed under the 1983 Paris Club agreement. [redacted] 25X1

[redacted] a new letter of intent would not be approved by the 25X1 IMF until mid-May at the earliest. We believe that agreement on a revised austerity program will be reached by this summer, although Neves must convince the Fund that he is serious about controlling inflation. [redacted] Neves regards as 25X1 important the need to continue austerity in order gradually to reduce inflation, which is running above 200 percent. [redacted] Finance Minister 25X1 Dornelles probably will go before the Brazilian Congress soon to present the administration's case for strict public-sector austerity. [redacted] 25X1

An accord with the IMF should pave the way for a rescheduling of foreign bank debt on terms similar to those negotiated by the outgoing government. [redacted] 25X1 [redacted] some concern that Brasilia will attempt to reopen the 25X1 negotiations and seek more favorable terms, which would further delay an agreement. For example, Neves may insist on some form of protection against a major rise in interest rates. [redacted] 25X1

[redacted] any efforts by the IMF to persuade Neves 25X1 to adopt austerity measures to bring inflation down dramatically will be rejected. Neves fears that his acquiescence to perceived excessive retrenchment measures could cause his coalition in Congress to unravel, making it difficult for the new administration to obtain sufficient backing for its planned political reforms. We believe a breakdown in negotiations with the IMF could push Neves to turn away and go without a Fund program. We believe that Brazil probably could last until the fourth quarter of 1985 without reaching agreements with the Fund and the banks, as a result of its currently favorable external accounts. [redacted] 25X1

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Argentina

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Meanwhile, recent Argentine press reports indicate that the IMF technical team will return to Buenos Aires on 25 March to review Argentina's performance under the stabilization program. The local press claims that the senior Argentine economic officials who were in Washington last week convinced the IMF to concentrate on adjustments to the 1985 targets and disregard compliance failures in the last quarter of 1984. [redacted] 25X1

[redacted] Last week, however, President Alfonsin told the US Ambassador that the IMF was taking a tough line on compliance and warned that if this attitude persisted, it could threaten the critical bank lending package. [redacted] the major explosion at the grain port of Bahia Blanca, by threatening to reduce foreign exchange and tax earnings, had added to Alfonsin's worries about the IMF. [redacted] 25X1 25X1 25X1 25X1

Our Embassy believes that the IMF is trying to force Alfonsin to rein in budget expenditures. Because of the slowing economy, rising unemployment, falling real wages, and parliamentary elections that are coming in November, however, Alfonsin is under growing pressure to boost spending. Even with some compliance waivers from the IMF, Argentina will be very hard pressed to stay within inflation and budget targets. [redacted] 25X1 25X1

REGIONAL SITUATIONS

Latin America

The Cartagena Group met last week in Brasilia and issued another communique. Among other Latin American countries, Venezuela is hopeful of completing its public-sector rescheduling, Chile reached preliminary agreement with the IMF on a new extended fund facility, and Peru remains at an impasse with its bank creditors. [redacted] 25X1 25X1

Cartagena Group Communique

Representatives of the Cartagena Group met on 16 March in Brasilia while attending the Brazilian presidential inauguration, according to press reporting. In a press communique, the Cartagena Group voiced their growing concern over persistent adverse international economic conditions that prolong painful adjustment, accentuate social conflicts, and frustrate the expectations of the member countries. The participants called for the Latin American governments to bring about improvement in the international economy by working through all world forums and holding talks with industrial governments. The communique concluded with the Cartagena Group agreeing to continue to coordinate their views for international forums and to keep with the goals outlined in the meetings held in Cartagena, Mar del Plata, and Santo Domingo. [redacted] 25X1

Venezuela

Caracas anticipates completion this month of the necessary documentation with bankers to conclude the rescheduling of public-sector debt. According to Embassy

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reporting, however, bankers want to give Caracas time to show greater progress in registering private sector debt and may delay signing until July. Bankers largely cleared the way for an agreement by dropping the demand that Venezuela provide specific assurances of private-sector debt repayment in the rescheduling offer sheet, accepting instead a separate statement to be issued by the Minister of Finance. The mechanics of the currency conversion option is one matter that is still unresolved. [redacted] 25X1

Chile

Santiago reached preliminary agreement with the IMF on 15 February for a 3-year extended fund facility, although the government — faced with extensive earthquake damage — has already asked for greater program target flexibility. The IMF will provide $750 million that will be disbursed in 4-5 tranches per year, [redacted] 25X1 25X1 Among the performance criteria for 1985 is a public-sector deficit target of 3.5 percent of GDP, which includes a 0.5 percentage point increase granted after the earthquake; last year's deficit was 4.6 percent. In a show of good faith, new Finance Minister Hernan Buchi announced a 10-percent devaluation of the peso on 1 March as the first of several steps to encourage exports, according to press reports. Additionally, Santiago advanced a scheduled tariff decrease from June to March. The IMF is expected to give the program formal approval no later than 17 May. [redacted] 25X1

The IMF agreement helped clear the way for the start of rescheduling talks with commercial bank in mid-March, [redacted] Chile projects 25X1 its commercial bank financing needs for the next three years at $1 billion in 1985, $700 million in 1986, and $200 million in 1987, [redacted] banks will provide 25X1 only $700-900 million this year. Santiago is seeking increased lending from development 25X1 banks to fill its financing gap this year, but the first disbursement of many of these loans will not occur until 1986. [redacted] 25X1

Chile's recent earthquake has inflicted between $500-800 million in damage. According to US Embassy reporting, the Inter-American Development Bank already has agreed to transfer $150 million set for Chilean project loans to immediate earthquake reconstruction efforts, and the bank plans to investigate the need for additional loans. The World Bank also is considering transferring some loans, and Chile has asked the IMF to consider additional help. Although these efforts will help, the amounts will not cover the full damages. In addition, damage to its ports and road networks will hurt Santiago's ability to import and export this year. We believe the Chilean economy, rather than growing the 4 percent in 1985 suggested in its IMF program, actually faces more than a 4 percent drop in GDP. [redacted] 25X1

Peru

Negotiations between Peru and its bank advisory committee in mid-February ended in tacit acknowledgment that, at best, government-bank relations would remain in a "holding pattern" until the inauguration of a new government in July, [redacted] 25X1 25X1 Most bankers were not fully satisfied with Finance Minister Garrido Lecca's package of patchwork measures — gradual increases in gasoline prices, increased sales taxes and interest rates, and an accelerated rate of devaluation. [redacted] 25X1 25X1 bankers insisted that Lima make further payments on interest arrearages, even if in installments. [redacted] 25X1 25X1 Peruvian officials pledged to try to

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keep arrearages below the 180-day limit. For its part, the bank advisory committee agreed to recommend that banks maintain trade credit lines at current levels and extend the rollover of maturities for 60 days. [redacted] 25X1

Relations with bankers nonetheless remain tense. The press reports that Peru paid $25 million on 22 February as agreed with bankers; this, however, is only half the amount Lima needs to pay by the end of March to keep its interest arrearages — which amount to $250 million — within the 180-day limit. Moreover, bankers refuse to discuss debt refinancing without an IMF agreement in place. Although the first round of presidential elections is set for next month, a runoff in June probably will be necessary, and the new president will not be inaugurated until late July. In our judgment, this probably will delay an IMF agreement until at least the third quarter of this year, causing arrearages to accumulate further. [redacted] 25X1

Ecuador

The general manager of the Central Bank stated last week, according to press reporting, that over 97 percent of Ecuador's creditor banks have accepted the commercial debt relief package in which Quito will receive $200 million in new money and have $4.3 billion of debt restructured. With the critical mass of financing from commercial banks in hand, the IMF Executive Board approved Ecuador's request for a one-year standby arrangement for about $103 million. Ecuador's previous arrangement for $157.5 million expired in July 1984. Ecuador's request for a multi-year rescheduling of official debt is on the Paris Club calendar for the week of 22 April. We believe that the creditors are sympathetic to some form of extended debt relief, but they will be unwilling to restructure more than three years of payments. [redacted] 25X1

Bolivia

Creditors and the Siles government implemented policy changes in late February aimed at breaking the financial impasse, but any progress likely will be short lived. Representatives of the World Bank, IMF, Inter-American Development Bank, Andean Development bank, US banks, and the US government formed a coordinating committee to deal with the Bolivian government on economic matters. [redacted] 25X1 this innovative team approach should ensure that Bolivia works with all agencies instead of only certain ones. Meanwhile, the US Embassy reports that most bankers are quietly supportive of Bolivian financial measures taken on 26 February, which included an increase in minimum interest rates on savings and the end of lending rate ceilings. Although the bank advisory committee has decided not to bring legal action to declare the Bolivian government in default, we believe debt rescheduling talks will remain suspended until La Paz resumes interest payments and implements an IMF-supported adjustment program. Moreover, we judge that the nationwide strike triggered by recent austerity measures also will impede any further progress in resolving Bolivia's debt problems. [redacted] 25X1

Eastern Europe

In Eastern Europe, Yugoslavia reached agreement with the IMF on a new standby arrangement, Poland's Paris Club negotiations were stalled because of Warsaw's failure to pay all creditors late interest charges due on the 1981 rescheduling agreement, and East Germany has obtained several medium-term loans. [redacted] 25X1

[redacted] 25X1

 [redacted] 25X1

Yugoslavia

On 14 March the Yugoslav Federal Assembly formally endorsed a draft agreement with the IMF for a 1985-86 standby credit of $300 million, opening the way for completion of rescheduling negotiations with Western banks and governments. According to Embassy reporting, Yugoslav Federal Secretary for Finance Klemencic characterized the talks leading up to the agreement as hard and complex but generally consistent with Yugoslavia's own economic policies. Perhaps in response to criticism that Yugoslavia yielded to overly austere terms, Klemencic noted that many of the Fund's targets were less restrictive or less binding than Belgrade's own economic resolutions adopted in late December 1984. [redacted] 25X1

Under the new agreement, Belgrade is to continue movement toward establishment of positive real domestic interest rates, devaluation of the dinar to offset inflation, and tight control over domestic credit and government expenditures, according to Embassy reporting. The IMF, however, agreed to a new formula for computing the inflation rate used as the basis for establishing positive real interest rates. As a result, Belgrade will not have to raise domestic interest rates as much to meet its program target. [redacted] 25X1

A meeting with the creditor governments is scheduled for 25 March at which time Belgrade is expected to continue to press for a multi-year rescheduling agreement (MYRA). Despite Belgrade's efforts, most key Western governments are expected to remain opposed to any MYRA in 1985. A second round of meetings is scheduled for the week of 20 May. Rescheduling talks with Yugoslavia's commercial bank creditors are expected to take place in mid-April. [redacted] 25X1

Poland

Rescheduling negotiations with the Paris Club on 4-5 March came to an impasse because of the Polish failure to pay all creditors the late interest charges due on the 1981 rescheduling agreement, according to Embassy reporting. The creditors were particularly surprised over Warsaw's refusal to make these payments to the West Germans since their bilateral agreement clearly specifies a formula to calculate penalty interest. Although many delegations were reluctant to break off talks at this stage, the Paris Club did agree to support West Germany in its attempt to receive full payment and the broader point that Warsaw must honor explicit terms of contracts. The Polish negotiators decided to refer the decision on payment of late interest and penalty back to Warsaw. Discussions with the Poles on rescheduling of 1985 debt did not take place although general terms were discussed among the creditors. The next Paris Club meeting is scheduled for the week of 22 April on the condition that the Poles resolve the problem of late interest payments to the satisfaction of the creditors. [redacted] 25X1

Paris Club creditors continued to show no interest in offering the Poles new credits because they view the country as "manifestly uncreditworthy". Warsaw, however, has made it clear to creditors that Poland would be unable to meet its commitments without new credits. According to Polish projections given to the Paris Club, Warsaw is counting on at least $850 million in new loans from government creditors to meet the almost $3 billion in debt service due this year. Warsaw recently requested new credit lines from at least 13 Paris Club members—mostly in the range of 50 to 60 percent of their annual exports to Poland. [redacted] 25X1

The Polish request for new credits has caused substantial disagreement between the West German Ministries of Economics and Finance, [redacted] 25X1

[redacted] 25X1

Economic Minister Bangemann hoped to reopen Polish access to Hermes guaranteed credits for up to 100 million DM during his 21-22 March trip to Warsaw as head of the West German-Polish Mixed Economic Commission. The Finance Ministry, however, opposed the move ostensibly on grounds that West Germany is legally restricted by budgetary law from renewing Polish access to these credits until rescheduling negotiations are completed. The Finance Ministry was also worried that if Bonn relaxed its restrictions and granted even a small amount of concessionary credit, the Poles would apply heavy pressure on the West German government for additional credit. According to Embassy reporting, the West Germans will not make any credit offer to the Poles at this week's meeting. 25X1

An IMF technical team held talks with Polish officials last month as the first step in processing Warsaw's application to join the organization, but many Western financial experts doubt Poland will enter the Fund before yearend. The delegation—the first to visit Warsaw officially since the United States lifted its sanction against membership—examined Polish economic data. While finding data on the balance of payments to be generally in line with IMF practices, the experts recommended changes in some domestic economic calculations. Another team is scheduled to arrive in Warsaw in mid-April to examine the current economic situation and plans to have a wide range contacts, including meetings with plant managers and union officials. 25X1

East Germany

A surge of medium-term borrowing has bolstered East Germany's financial strength, giving East German economic managers greater flexibility than they have enjoyed in years. Since last June, East Berlin has raised about $1.4 billion in seven untied credits with tenors of four to seven years on increasingly favorable terms, after several years of being excluded from the medium-term market. The last two credits — $400 million in December and $500 million this month — were increased from $150 million due to heavv oversubscription. 25X1

We believe East Berlin probably wants most to reduce its vulnerability to any sharp cutback in bank lending of the sort that nearly forced a liquidity crisis in 1982-83 and necessitated painful domestic adjustment measures. We expect East Germany to seek additional medium-and long-term credits to reduce its still considerable short-term debt. At the same time, East Berlin could be taking advantage of its improving creditworthiness to reduce interest expenses and forge closer links with some Western banks. Moreover, East Germany also may be positioning itself to boost imports of capital goods to make up for the decline in investment in recent years. 25X1

Asia

Philippines

The refusal of the National Commercial Bank of Saudi Arabia (NCB) to participate in the new money proposal for the Philippines continues to delay signing of the long-awaited financial rescue package. The Saudis, with $155 million in Philippine exposure including $78 million in oil credits to the Philippine National Oil Company (PNOC), are Manila's 27th largest commercial bank creditor. According to Embassy reporting, the Saudis have refused to participate in any rescheduling effort since the first Mexico exercise in 1982. In most of these cases, the Saudis were a small creditor and other banks covered their contribution. this 25X1
time the bank advisory committee expected the Saudis to contribute $13 million in new money — an amount too large to be absorbed by other creditors. 25X1

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While the Saudis have expressed their unhappiness on several points, the key to the controversy appears to be the bank advisory committee's method of calculating exposure. [redacted] the base used for determining a participant's share in the new money package includes all loans outstanding, both short-term and long-term. This is of considerable concern to the Saudis as NCB has engaged in a number of short-term oil deals with the PNOC. [redacted] 25X1 25X1 25X1

According to [redacted] State Department reporting, the Saudis have indicated that their participation would be forthcoming in an agreement that: required less new money, established a separate trade facility for NCB, and included a clause that allowed trade outstandings to be converted to peso equity investments. The bank advisory committee made a provision to incorporate the third point into the rescheduling package, but the Saudis held firm on the issue of a separate agreement. The bank committee is scheduled to meet this week to reassess the situation. According to State Department reporting, bankers are worried that other creditors may withdraw their commitments if the Saudis do not come around. [redacted] 25X1 25X1 25X1

The first review of the Philippine IMF standby arrangement began on 4 March and should conclude this week. [redacted] the review will center on three outstanding issues: the reduction of reserve money, the appreciation of the peso, and the inclusion of the National Food Authority and Human Settlements Development Corporation in the list of Philippine government entities to fall under IMF monitoring. [redacted] the review will be formally considered by the IMF Executive Board in late April. [redacted] the Philippines must pass the program review to receive a $150 million disbursement of two installments of the standby loan originally scheduled to be released in early March and late April. [redacted] 25X1 25X1 25X1 25X1 25X1

Africa/Middle East

In Africa, Nigeria issued a second tranche of promissory notes resulting from last April's rescheduling agreement with uninsured creditors, and Somalia obtained $53 million in loans from the IMF. [redacted] 25X1

Nigeria

According to Embassy reporting, Nigeria has issued a second tranche of promissory notes resulting from last April's agreement to reschedule $6-8 billion in uninsured trade credits. Local bankers told the Embassy in Lagos that approximately $80 million in notes were issued late last week. The first tranche of notes, which was issued in November 1984, totalled $258 million. According to Embassy reporting, bankers expect the bulk of the promissory notes — another $2.5 billion — to be issued by mid-year. Claims under the terms of the April agreement have far exceeded the Central Bank's expectations and have resulted in lengthy processing delays. [redacted] 25X1

Talks with the IMF remain at a stalemate. [redacted] Head of Civil Service Longe has personally forwarded a draft memorandum to Head of State Buhari recommending that the government accept the economic conditions set down by the IMF. Longe and the government economists expect Buhari to approve their recommendation before mid-April and to forward the memorandum to the council for ratification. We believe, however, that Longe's 25X1 25X1

[redacted] 25X1

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expectations are highly optimistic and that an agreement with the IMF is unlikely to be reached in the near term. Nonetheless, the government remains concerned that a decision to approach the IMF will be viewed as buckling under and could undercut its political power base. 25X1

Somalia

In late February, the IMF approved $53 million in new loans for Somalia. According to IMF reporting, $22 million will be drawn over the next year as part of a standby arrangement, and $32 million became available immediately under the compensatory financing facility. Somalia's 1985 adjustment program involves major reforms of the interest rate structure and the domestic banking system. 25X1

Earlier this month, Somalia met with its Paris Club creditors. According to Embassy reporting, a $20 million discrepancy in debt estimates and a misunderstanding on interest payments nearly caused the negotiations to collapse. An agreement, however, was reached calling for 95 percent of principal, interest, and arrearages to be rescheduled over a 9-year period including five years of grace. The remaining 5 percent downpayment will be spread over the grace period. The Paris Club expects negotiations with bilateral creditors to be concluded by 30 June. In the meantime, the Somalis will make minimum monthly payments of $200,000 into a special account; the monthly payments will be recalculated once the terms of the bilateral reschedulings are finalized. 25X1

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